3Q 2016 Market Insights
Brexit Bombshell! What Now?
Michael Paciotti, CFA

*"The best argument against democracy is a five-minute conversation with the average voter."*

- *Sir Winston Churchill*

Apologies to anyone that may have been offended by the Sir Winston Churchill quote above, but on the weekend of June 25th and 26th, the top searched term on the internet in the U.K. was, 'what is Brexit?' The second most searched term… 'What is the EU?' Beginning June 23rd, and extending into the wee hours of June 24th, the U.K. set the world on its head, as the unlikely turned impossible outcome became reality. Brexit happened. U.K. voters, by a margin of 52% to 48%, voted to leave the European Union (EU), the consequences of which many did not even understand before casting their ballot. In fact, as Google search results would imply, many did not even know what the European Union was!

The term Brexit is simply a media buzzword that refers to the British exit from the EU, or for short, Brexit. For those who are not familiar, the EU is an organization of 28 (soon to be 27 European nations) with the goal of enabling the free movement of people, capital, and goods and services among its member states. The EU traces its origins back to 1958 and the European Coal and Steel Community, which has morphed and evolved many times over the last 50 plus years into the entity that we see today. As Brexit became reality, it sent shockwaves through currency markets, as well as global equity and fixed income markets. On Friday June 24th, the British Pound declined by 8%, while European stocks sagged more than 7%. To put the extreme nature of this in perspective, based on 35 years of daily data, the 1-day change in the pound was a twelve standard deviation (sigma) event. This carries with it a statistical probability of approximately zero! Almost equally shocking, this was backed up by a 3.5% move on the following day, itself a six standard deviation (sigma) move or a 1/1,014,713,328 outcome!

While Brexit news has dominated headlines across television, print, and internet media outlets, few have offered anything of real substance concerning the implications. Some have made some sensational statements. Some have even off-handedly offered specific guesstimates…the U.K. or Europe will easily suffer a decline of…pick a round number, say 10%. However, few have substantiated their claims. The reason...Brexit is far reaching, with many 3rd, 4th or xth derivative effects that cannot be fully understood, or for that matter anticipated, until they begin to work through the process. Sadly, at this point we are no different. We don't have a complete understanding either. However, we do believe that we have a good feel for how this will impact us, within the context of how we invest. Therefore, within the scope of our expertise, valuations and fundamentals of global financial assets, we would like to begin to lay out a framework for evaluating Brexit's impact on financial markets. That is, how does all of this affect your investment dollars in U.K. and European equities? How much of the Brexit sell off is justifiable? How much of it is simply a panic reaction to the unknown? The topic of this quarter's Market Insights, 'Brexit Bombshell! What now?'

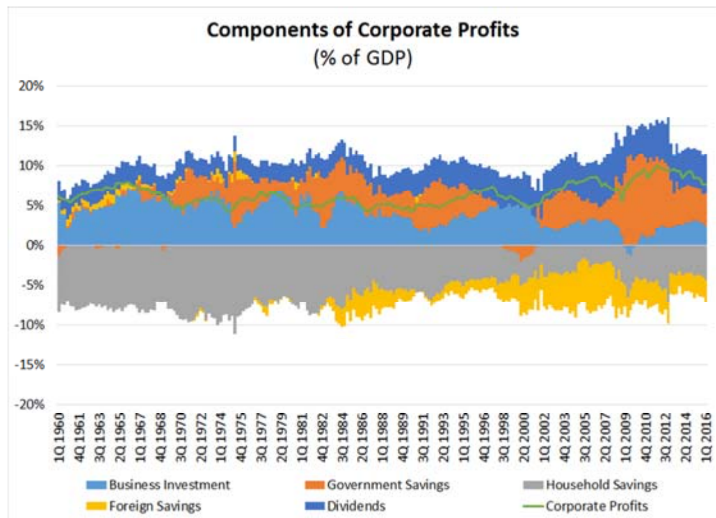
Starting at the Top

In investing, everything starts and ends with how big the pie is, the pie being a nation or region's Gross Domestic Product. Now, as we have stated many times before, the best performing capital markets are rarely those exhibiting the highest or fastest growing GDP, so please don't misunderstand our point. The reason for this is that markets are very efficient at pricing in yesterday's news. If GDP has been good, then it must be even better tomorrow to cause equity prices to rise. As a result, nations emerging from a recession, or dare I say even a depression, typically provide better buying opportunities than the obvious high growth GDP nation. Why is this? Well, expectations are low and easier to overachieve. The same dynamic exists with profits. High profit margin environments typically produce lower equity returns and vice versa. The question as it relates to the Brexit is then simple. As investors, do we own or are we buying today, a stake in a pie that is about to shrink? The pie being Europe and the U.K. As we stated a moment ago, change drives capital market prices. In this case, a change for the worse could drive prices lower.

The lifeblood of any investment is profits and earnings. In our *3q 2013 Market Insights, The Paradox of Profits,* we offered the following formula for decomposing aggregate US profits.

Profits = Business Investment – Household Savings – Gov't Savings – Foreign Savings + Dividends

In this instance, we will use it to illustrate how GDP and profits are intermingled and function. It is important to remember, the framework is for aggregate level profits in a closed economy. In this case, it is especially useful given the global economy is closed, while various national and regional economies are not. At a global level, imports and exports are a zero sum game, whereas open economies can and do run trade surpluses and deficits, as they exchange goods with other countries. This important point will become more obvious later.




*Corporate profits are a function of business investment, household savings, government savings, foreign savings, and dividends. Declining business investment appears to be the most immediate risk to the U.K. Longer term, but more remote, a disruption of trade could potentially impact savings, which is a function of wages minus consumption. Given that a trade agreement is in the best interest of all parties, we view the likelihood of a disruption of trade as exceptionally remote.*

*Source: FRB, iCM Capital Markets Research*

In simple terms, business investment and dividends (received by consumers and spent) make a positive contribution to profits, while savings of any sort remove dollars from circulation and reduce overall profits. Wages and consumption are both important pieces to the puzzle, but are netted together to form savings. In this case, negative savings, or borrowing, is a positive contributor. Most of this is fairly intuitive. Anything that adds to spending has a positive impact on profits, while anything that subtracts from spending, like savings at any level, actually reduces profits.

Wages are a little less intuitive until you consider them collectively with consumption. A single business can cut the wages of its workforce without affecting the consumption of its own product. However, if all business across the US, U.K., and Europe simultaneously slash wages where are consumers going to get money to buy goods? Money to spend comes primarily from wages. Less wages equals less spending power and lower profits for businesses as a whole.

Finally, business investment has typically been the primary positive contributor to corporate profits. This occurs at the aggregate level because cash outlays for inventory, property, plant and equipment are not immediately expensed, but revenues received by the seller are recognized as income upon receipt. The second observation about business investment, which may not be so surprising, is that most dips in corporate profits correspond with the initial dip in business investment at the downturn of the business cycle. This could be relevant in our current circumstance.

Impacts on the U.K. & Europe

In the case of the U.K., the most obvious drag on profits might come from declining business investment or potentially business disinvestment. Many U.K. firms with global reach, like those in the financial services industry, do a great deal of business in Europe. The potential exists that many of these firms may need to relocate operations from the U.K. to Europe in order to continue to serve these markets. Notice how we use the terms 'may' and 'potentially'? Unfortunately, we don't know at present and won't know for some time. Chances are in fact remote that this will happen, but it could, so the market must account for this possibility in its current price. Regardless of the probability, how eager will these firms be to invest in new infrastructure or expand the pace of hiring with this unknown hanging out there? It is highly doubtful that business investment in the U.K. will do anything but decline in the short term. Over the long term, however, it is much less clear, with some believing that this could impact U.K. GDP in 2030 anywhere from -.8% and +.6%[1]. While in the short term, almost all agree that Brexit will drag on U.K. GDP.

What about Europe? Europe has the potential to be negatively impacted by unfavorable trade terms with one of its largest trading partners. Again, this seems to be a remote possibility because it is in both parties' interests to work out a deal. In this case, consumption and wages decline assuming that there is no demand for these goods elsewhere across the globe. Trade agreement aside, the U.K.'s loss could be Europe's gain. Any business disinvestment in the U.K. could and likely would end up in Europe, most likely France or Germany. All of the dollar disinvestment or drag on the U.K.'s economy would be met with an equal dollar boost to the EU, as the infrastructure is relocated. Brexit, for the most part, should be a transfer payment from one entity to another, with the most likely loser being the U.K. and the most likely beneficiary being continental Europe. This is the open economy that we mentioned earlier. GDP can be gained or lost to the benefit or expense of another. That is, transactions can occur outside of the local economy transporting that wealth to another external economy in this case from the U.K. to Europe.

The Risk

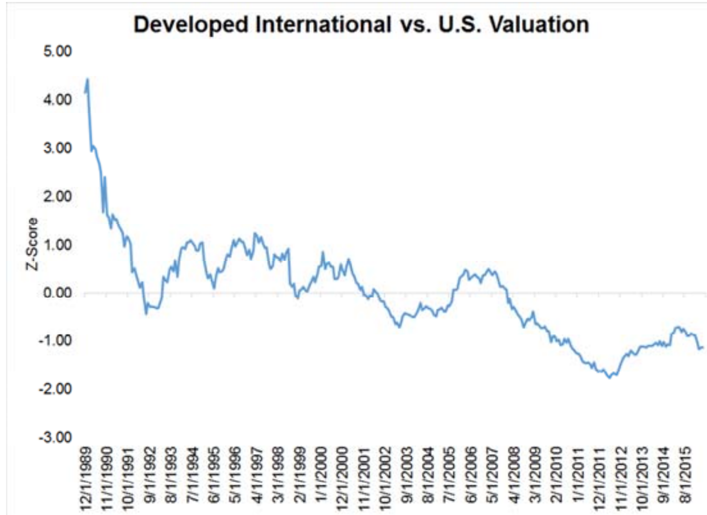
So how does this all go bad? We mentioned one way previously. If trade is disrupted, consumption will decline, negatively affecting profits and earnings. As a result, it will alter the valuation of the asset by causing the E (Earnings) portion of the P/E ratio to erode. This is similar to what we've witnessed in the US over the last 18 months. Profits declined, earnings on the S&P 500 fell from $105 to $89, and the P/E multiple ballooned to 23x earnings with hardly any upward movement in price. Closely related to trade and correspondingly earnings is economic uncertainty by the people. If fear grips consumers, they spend less and save more. This reaction is purely psychological, but could have a real impact similar to trade disruption.

Another way Brexit can end badly is if a widespread, or systemic levered risk is identified. Think sovereign debt, or real estate impacting the banks as an example of this type of risk. In each of these cases, there was a seemingly benign asset, real estate and foreign treasuries, which was perceived to be safe and was held in large amounts by levered

[1] Source: Open Europe & Ciuriak Consulting

financial institutions. In 2008, real estate values fell, causing bank failures and the ensuing credit crisis. In 2011, nearly the same thing happened with foreign treasuries, as Greece and other nations appeared to be in jeopardy of defaulting on their debt.

At this point, a systemic risk factor like this does not appear to exist. However, one event that could change this scenario is if another nation, who is part of the European Union, and uses the Euro as their currency, decides to exit the EU. This would likely cause a negative revaluation of the currency, an asset that was perceived to be safe and is held widely by many financial institutions. With Brexit, the U.K. is on its own currency so this scenario does not apply to the Brexit decision. Additionally, most other nations, on a stand-alone basis, are far too dependent on the EU to even consider leaving. One indicator worth watching is the exposure of US banks to U.K. creditors through conventional and derivatives markets, which some estimate at over a trillion dollars. Again, a remote possibility of being an issue, but something worth being mindful of nonetheless.




*Valuations of developed international equities relative to the US are now approaching historic lows. Our research has historically shown an inverse relationship between current valuation and future relative performance.*

Source: MSCI, Russell, iCM Capital Markets Research

Now, allow me to throw an additional curve into the mix. Does any of this really matter? In the context of how we invest, unless trade is disrupted or some systemic levered risk emerges, we don't think it does.

The global investment world can essentially be broken down into four parts. There is the US, Developed Nations excluding the US, the Emerging World, and the Frontier Markets. What we are talking about is included in the developed nations excluding the US component. In simple terms, this is Europe, the U.K., and Japan, the primary components of the MSCI EAFE Index. As long as the transfer of infrastructure or wealth occurs within this constituency, it doesn't matter. A minus on the U.K. balance sheet should presumably be received as a plus on the European balance sheet, making the net effect to index earnings exactly zero. This is the concept of a closed economy that we also mentioned earlier. As seen in the chart above, the developed world (EAFE) was previously undervalued. Brexit related performance has simply made the asset class even more attractively valued.

## The Reaction

So why are we seeing markets react like this now? Uncertainty is risk. What if some of the things that we identified manifest into reality? What if other nations elect to leave the EU? Simple finance theory tells us that with increased risk, comes a higher return requirement from investors. To get a higher required return, by simple math, the current price relative to earnings or P/E must decline. In time, investors will digest the facts, unlikely outcomes will begin to fall by the wayside, and new risks will emerge along the way. There will be periods of fits and starts with markets swinging between fear and greed. This is normal. This is how markets effectively price risk. They wander their way to fair value, but rarely get there in a straight line.

Thoughtfully, we remain exceptionally confident in our strategy and current positioning. We are confident in our ability to process information from an unemotional perspective and are equipped to respond as needed if a shift in strategy is justifiable. Until then, we encourage investors to remain focused on the long-term and avoid being emotional, as difficult as that me be. A steady measured approach rather than an emotional response is often best. Thank you for your trust and confidence.



Integrated Capital Management

410 Spruce Street, 4th Floor, Scranton, PA 18503

Phone: (570)344-0100, Email: info@icm-invest.com

www.icm-invest.com